



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-101812-07]

RIN 1545-BI83

Reimbursed Entertainment Expenses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations explaining the exception to the deduction limitations on certain expenditures paid or incurred under reimbursement or other expense allowance arrangements. These proposed regulations affect taxpayers that pay or receive advances, allowances, or reimbursements under reimbursement or other expense allowance arrangements. These proposed regulations clarify the rules for these arrangements.

DATES: Comments or a request for a public hearing must be received by **INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-101812-07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-101812-07), Courier's Desk, Internal Revenue

Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-101812-07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Patrick Clinton, (202) 622-4930 ; concerning submissions of comments and/or requests for a public hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) explaining the exception to the section 274(a) and (n) deduction limitations on certain expenditures paid or incurred under reimbursement or other expense allowance arrangements. The proposed regulations clarify the definition of reimbursement or other expense allowance arrangements for purposes of section 274(a) and (n) and how the deduction limitations apply to reimbursement arrangements between three parties, as addressed in Transport Labor Contract/Leasing, Inc. v. Commissioner, 461 F.3d 1030 (8th Cir. 2006), rev'g 123 T.C. 154 (2004) (TLC), and Rev. Rul. 2008-23 (2008-18 I.R.B. 852).

Section 274(a)(1) limits deductions for certain expenses for entertainment, amusement, or recreation activities and for facilities used in connection with entertainment, amusement, or recreation activities. Section 274(n)(1) generally limits the amount allowable as a deduction for any expense for food, beverages, entertainment activities, or entertainment facilities to 50 percent of the amount otherwise

allowable. However, the limitations of sections 274(a)(1) and 274(n)(1) do not apply to an expense described in section 274(e)(3).

In general, section 274(e)(3) excepts from the limitations of section 274(a) expenses a taxpayer pays or incurs in performing services for another person under a reimbursement or other expense allowance arrangement with the other person. The exception applies if the taxpayer is an employee performing services for an employer and the employer does not treat the reimbursement for the expenses as compensation and wages to the taxpayer (section 274(e)(3)(A)). In that case, the employee is not treated as having additional compensation and has no deduction for the expense. The employer bears and deducts the expense and is subject to the deduction limitations. See §1.274-2(f)(2)(iv)(b) of the Income Tax Regulations.

If the employer treats the reimbursement as compensation and wages, the employee may be able to deduct the expense as an employee business expense. The employee bears the expense and is subject to the deduction limitations. Section 1.274-2(f)(2)(iv)(b)(1). The employer deducts an expense for compensation, which is not subject to the deduction limitations under section 274. Section 1.274-2(f)(2)(iv)(b)(2); see also section 162.

The section 274(e)(3) exception also applies if the taxpayer performs services for a person other than an employer and the taxpayer accounts (substantiates, as required by section 274(d)) to that person. Section 274(e)(3)(B). Therefore, in a reimbursement or other expense allowance arrangement in which a client or customer reimburses the expenses of an independent contractor, the deduction limitations do not apply to the independent contractor to the extent the independent contractor accounts to the client

by substantiating the expenses as required by section 274(d). If the independent contractor is subject to the deduction limitations, the limitations do not apply to the client. See §1.274-2(f)(2)(iv)(a).

TLC applied these rules to a reimbursement arrangement involving three parties in the trucking industry. In some cases, truck drivers are paid wages and a per diem meals allowance by a company that leases the drivers to a client trucking company. The client trucking company pays the leasing company for the driver's expenses plus an additional fee, and the parties deduct their respective expenses. Under section 274(e)(3), if the parties have a reimbursement or other expense allowance arrangement, the section 274(n) limitation applies to only one party.

TLC was a leasing company that paid truck drivers a per diem allowance that it did not treat as compensation. TLC billed the client leasing the drivers for the drivers' wages and per diem allowances, and the client paid TLC. The Tax Court applied the section 274(n) limitation to TLC as the drivers' common law employer subject to section 274(e)(3)(A).

The Eighth Circuit stated that the Tax Court should have considered the section 274(e)(3)(B) exception between TLC and the client. TLC was providing services to its clients under a reimbursement or other expense allowance arrangement and accounted to the client. Therefore, TLC qualified for the exception in section 274(e)(3)(B) and the incidence of the section 274(n) limitation was on the client that bore the per diem expense.

Rev. Rul. 2008-23 acquiesces in the result in TLC and similarly holds that the party that ultimately bears the expense in a three-party reimbursement arrangement is

subject to the section 274(n) limitation. The revenue ruling clarifies that a party's status as a common law employer is not relevant to the section 274(n) analysis, which the Eighth Circuit's opinion could be read to imply.

Rev. Rul. 2008-23 clarifies another issue raised by the TLC opinion. To define the term reimbursement or other expense allowance arrangement for purposes of section 274(e)(3), the Eighth Circuit looked to §1.274-2(f)(2)(iv)(a), which provides that the term reimbursement or other expense allowance arrangement in section 274(e)(3) has the same meaning as in section 62(2)(A) (dealing with employee business expenses, later renumbered 62(a)(2)(A)), but without regard to whether the taxpayer is an employee of the person for whom the taxpayer provides services. Thus, TLC defined reimbursement or other expense allowance arrangement for purposes of section 274(e)(3) by reference to section 62(a)(2)(A) and the regulations at §1.62-2, which provide the rules for the employee reimbursement arrangements called accountable plans. The TLC court's definition is inaccurate to the extent it relies on the accountable plan rules, which cover employee reimbursement arrangements only, in determining the existence of a reimbursement or other expense allowance arrangement for purposes of identifying who bears the expense under section 274(e)(3)(B).

Rev. Rul. 2008-23 clarifies that the §1.274-2(f)(2)(iv)(a) reference to section 62(2)(A) predates the enactment of section 62(c), which addresses certain arrangements not treated as reimbursement arrangements, and the accountable plan regulations, which govern employer-employee reimbursement arrangements and their employment tax consequences. Therefore, Rev. Rul. 2008-23 holds that the section

274(e)(3) exception may apply to an expense reimbursement arrangement without regard to whether it is an accountable plan.

Explanation of Provisions

1. Definition of Reimbursement or Other Expense Allowance Arrangement

The focus of the accountable plan rules under section 62(c) and the applicable regulations is the taxability of reimbursements and allowances paid to employees and their treatment for employment tax purposes. The purpose of the rules under section 274(e)(3) is to provide an exception to the section 274(a) and (n) deduction limitations. Given these different purposes, the proposed regulations amend §1.274-2(f)(2)(iv)(a) to provide an express definition of reimbursement or other expense allowance arrangement for purposes of section 274(e)(3) independent of the definition in section 62(c).

Under the proposed regulations, a reimbursement or other expense allowance arrangement involving employees is an arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (the employer, its agent, or a third party) for expenses the employee pays or incurs in performing services as an employee. A reimbursement or other expense allowance arrangement involving persons that are not employees is an arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs in performing services if either (1) a written agreement between the parties expressly provides that the client or customer will reimburse the independent contractor for expenses that are subject to the deduction limitations, or (2) a written agreement between the parties expressly identifies

the party that is subject to the limitations under §1.274-2(a) – (e) and section 274(n). Specific comments are requested on the definition of reimbursement or other expense allowance arrangement and on alternative definitions or approaches that would ensure that the deduction limitations apply to one of the parties to an expense reimbursement arrangement.

2. Two-Party Reimbursement Arrangements

The proposed regulations clarify that the rules for applying the exceptions to the section 274(a) and (n) deduction limitations apply to reimbursement or other expense allowance arrangements with employees, whether or not a payor is an employer. Under the proposed regulations, a payor includes an employer, an agent of the employer, or a third party. For example, either an independent contractor or a client or customer may be a payor of a reimbursement arrangement. Thus, any party that reimburses an employee is a payor and bears the expense if the payment is not treated as compensation and wages to the employee.

In the case of a reimbursement or other expense allowance arrangement between an independent contractor and a client or customer that includes an agreement expressly providing that the client or customer will reimburse the independent contractor for expenses that are subject to the deduction limitations, the deduction limitations do not apply to an independent contractor that accounts to the client within the meaning of section 274(d) and the associated regulations, but they do apply to the independent contractor and not to the client if the independent contractor fails to account to the client. Alternatively, the parties may enter into an express agreement identifying the party that is subject to the deduction limitations.

3. Multiple-Party Reimbursement Arrangements

The proposed regulations include an example illustrating how the rules apply to multiple-party reimbursement arrangements. Multiple-party reimbursement arrangements are separately analyzed as a series of two-party reimbursement arrangements. Thus, for example, an arrangement in which (1) an employee pays or incurs an expense subject to limitation, (2) the employee is reimbursed for that expense by another party (the initial payor), and (3) a third party reimburses the initial payor's payment to the employee, is analyzed as two two-party reimbursement arrangements: one arrangement between the employee and the initial payor, and another arrangement between the initial payor and the third party. Examples illustrate that the limitations apply to the party that receives an accounting and that ultimately bears the expense.

Effective/Applicability Date

The regulations are proposed to apply to expenses paid or incurred in taxable years beginning on or after the date these regulations are published as final regulations in the **Federal Register**. However, taxpayers may apply these regulations for taxable years beginning before the date these regulations are published as final regulations in the **Federal Register** for which the period of limitations under section 6511 has not expired.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5)

does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The IRS and Treasury Department request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Jeffrey T. Rodrick and Patrick Clinton of the Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.274-2 also issued under 26 U.S.C. 274(o). * * *

Par. 2. Section 1.274-2 is amended by revising paragraph (f)(2)(iv) to read as follows:

§1.274-2 Disallowance of deductions for certain expenses for entertainment, amusement, recreation, or travel.

* * * * *

(f) * * *

(2) * * *

(iv) Reimbursed entertainment, food, or beverage expenses--(A) Introduction. In the case of any expenditure for entertainment, amusement, recreation, food, or beverages made by one person in performing services for another person (whether or not the other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1) apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. If an expenditure of a type described in this paragraph (f)(2)(iv) properly constitutes a dividend paid to a shareholder, unreasonable compensation paid to an employee, a personal expense, or other nondeductible expense, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Code.

(B) Reimbursement arrangements involving employees. In the case of an employee's expenditure for entertainment, amusement, recreation, food, or beverages in performing services as an employee under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party), the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1) apply--

(1) To the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid to the employee and as wages to the employee for purposes of withholding under chapter 24 (relating to collection of income tax at source on wages); and

(2) To the payor to the extent the reimbursement or other payment of the expense is not treated as compensation and wages paid to the employee in the manner provided in paragraph (f)(2)(iv)(B)(1) of this section (however, see paragraph (f)(2)(iv)(C) of this section if the payor receives a payment from a third party that may be treated as a reimbursement arrangement under that paragraph).

(C) Reimbursement arrangements involving persons that are not employees. In the case of an expense for entertainment, amusement, recreation, food, or beverages of a person who is not an employee (referred to as an independent contractor) in performing services for another person (a client or customer) under a reimbursement or other expense allowance arrangement with the person, the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1) apply to the party expressly identified in an agreement between the parties as subject to the limitations. If

an agreement between the parties does not expressly identify the party subject to the limitations, the limitations apply--

(1) To the independent contractor (which may be a payor described in paragraph (f)(2)(iv)(B) of this section) to the extent the independent contractor does not account to the client or customer within the meaning of section 274(d) and the associated regulations; and

(2) To the client or customer if the independent contractor accounts to the client or customer within the meaning of section 274(d) and the associated regulations. See also §1.274-5.

(D) Reimbursement or other expense allowance arrangement. The term reimbursement or other expense allowance arrangement means--

(1) For purposes of paragraph (f)(2)(iv)(B) of this section, an arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (the employer, its agent, or a third party) for expenses the employee pays or incurs; and

(2) For purposes of paragraph (f)(2)(iv)(C) of this section, an arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs if either--

(a) A written agreement between the parties expressly states that the client or customer will reimburse the independent contractor for expenses that are subject to the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1); or

(b) A written agreement between the parties expressly identifies the party subject

to the limitations.

(E) Examples. The following examples illustrate the application of this paragraph (f)(2)(iv).

Example 1. (i) Y, an employee, performs services under an arrangement in which L, an employee leasing company, pays Y a per diem allowance of \$10x for each day that Y performs services for L's client, C, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food and beverages that Y pays in performing services as an employee. L enters into a written agreement with C under which C agrees to reimburse L for any substantiated reimbursements for travel expenses, including meals, that L pays to Y. The agreement does not expressly identify the party that is subject to the deduction limitations. Y performs services for C while traveling away from home for 10 days and provides L with substantiation that satisfies the requirements of section 274(d) of \$100x of meal expenses incurred by Y while traveling away from home. L pays Y \$100x to reimburse those expenses pursuant to their arrangement. L delivers a copy of Y's substantiation to C. C pays L \$300x, which includes \$200x compensation for services and \$100x as reimbursement of L's payment of Y's travel expenses for meals. Neither L nor C treats the \$100x paid to Y as compensation or wages.

(ii) Under paragraph (f)(2)(iv)(D)(1) of this section, Y and L have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to Y, under section 274(e)(3)(A) and paragraph (f)(2)(iv)(B)(1) of this section, Y is not subject to the section 274 deduction limitations. Instead, under paragraph (f)(2)(iv)(B)(2) of this section, L, the payor, is subject to the section 274 deduction limitations unless L can meet the requirements of section 274(e)(3)(B) and paragraph (f)(2)(iv)(C) of this section.

(iii) Because the agreement between L and C expressly states that C will reimburse L for expenses for meals incurred by employees while traveling away from home, under paragraph (f)(2)(iv)(D)(2)(a) of this section, L and C have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(C) of this section. L accounts to C for C's reimbursement in the manner required by section 274(d) by delivering to C a copy of the substantiation L received from Y. Therefore, under section 274(e)(3)(B) and paragraph (f)(2)(iv)(C)(2) of this section, C and not L is subject to the section 274 deduction limitations.

Example 2. (i) The facts are the same as in Example 1 except that, under the arrangements between Y and L and between L and C, Y provides the substantiation of the expenses directly to C, and C pays the per diem directly to Y.

(ii) Under paragraph (f)(2)(iv)(D)(1) of this section, Y and C have established a reimbursement or other expense allowance arrangement for purposes of paragraph

(f)(2)(iv)(C) of this section. Because Y substantiates directly to C and the reimbursement payment was not treated as compensation and wages paid to Y, under section 274(e)(3)(A) and paragraph (f)(2)(iv)(C)(1) of this section Y is not subject to the section 274 deduction limitations. Under paragraph (f)(2)(iv)(C)(2) of this section, C, the payor, is subject to the section 274 deduction limitations.

Example 3. (i) The facts are the same as in Example 1, except that the written agreement between L and C expressly provides that the limitations of this section will apply to C.

(ii) Under paragraph (f)(2)(iv)(D)(2)(b) of this section, L and C have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(C) of this section. Because the agreement provides that the 274 deduction limitations apply to C, under section 274(e)(3)(B) and paragraph (f)(2)(iv)(C) of this section, C and not L is subject to the section 274 deduction limitations.

Example 4. (i) The facts are the same as in Example 1, except that the agreement between L and C does not provide that C will reimburse L for travel expenses.

(ii) The arrangement between L and C is not a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3)(B) and paragraph (f)(2)(iv)(D)(2) of this section. Therefore, even though L accounts to C for the expenses, L is subject to the section 274 deduction limitations.

(F) Effective/applicability date. This paragraph (f)(2)(iv) applies to expenses paid or incurred in taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 3. Section 1.274-8 is revised to read as follows:

§1.274-8 Effective/applicability date.

Except as provided in §§1.274-2(a), 1.274-2(e), 1.274-2(f)(2)(iv)(F) and 1.274-5, §§1.274-1 through 1.274-7 apply to taxable years ending after December 31, 1962.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2012-18691 Filed 07/31/2012 at 8:45 am; Publication Date: 08/01/2012]